

**WRITTEN DECISION - NOT FOR PUBLICATION**

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UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF CALIFORNIA

In re:	}	Bk. No. 17-00138-LA7
PECK JEEP EAGLE INC.,	}	Chapter 7
Debtor.	}	<b>MEMORANDUM DECISION</b>
	}	
	}	

**I.  
INTRODUCTION**

The matter before the Court is the chapter 7 trustee’s objection to Claim No. 2-1 filed by the Department of Treasury, IRS (“IRS”). At the conclusion of the March 25, 2021 hearing on the claim objection, the Court took the matter under submission to consider the IRS’ procedural argument that a claim objection is not the proper vehicle to challenge the IRS’ lien or to subordinate its allowed claim. Based upon the evidence provided, arguments made, relevant law, and for the reasons more fully set forth below, the Court agrees that: (1) a claim objection, or a contested matter, is not a proper vehicle to determine the validity, priority, or extent of a lien or to subordinate an allowed claim; and (2) if the parties are unable to settle their dispute, the Trustee must file an adversary proceeding to challenge the IRS’ lien and/or to subordinate its claim.

## II.

## FACTUAL BACKGROUND

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3 Debtor filed this voluntary chapter 7 bankruptcy case on January 12, 2017, and the  
4 Trustee was appointed. In response to the Trustee's notice of the need to file proofs of  
5 claims, the IRS filed Proof of Claim No. 2-1 in the amount of \$415,871.96, indicating that  
6 \$299,446.67 is unsecured and \$117,425.29 is secured ("Claim"). The Debtor objected to the  
7 unsecured portion of the Claim, and by prior uncontested order the unsecured portion of the  
8 Claim was disallowed in its entirety [ECF No. 58].<sup>1</sup>

9 Thereafter, the Trustee filed her claim objection to the \$117,425.29 asserted to be  
10 secured ("Secured Claim").<sup>2</sup> The Trustee's objection asserted that portions of the Secured  
11 Claim are for penalties, or interest on penalties, so the lien securing these amounts is  
12 avoidable and/or the amounts are subject to subordination pursuant to 11 U.S.C. §§ 724(a)  
13 and 726(a)(4). The IRS filed opposition to the Trustee's objection contending, *inter alia*,  
14 that proceedings to determine the validity, priority, or extent of a lien, and proceedings to  
15 subordinate any allowed claim, cannot be brought by filing a claim objection. The IRS  
16 contends that these matters are properly brought through the filing of an adversary  
17 proceeding, per Federal Rules of Bankruptcy Procedure 7001(2) and 7001(8).<sup>3</sup> The Trustee  
18 responded that she routinely resolves these types of disputes with the IRS without the  
19 necessity of filing an adversary proceeding, and the IRS' filing of its Claim submits the IRS  
20 to this Court's jurisdiction to determine the Claim's validity. However, the Trustee  
21 indicated her willingness to file an adversary proceeding if necessary.

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26 <sup>1</sup> The unsecured portion asserted liability for failure to withhold payroll taxes; however, the Debtor owed no payroll  
taxes because it had closed its business and had no employees and had filed its final tax return confirming the same.

27 <sup>2</sup> The Secured Claim is comprised of \$3,903.68 (taxes); \$101,332.70 (prepetition penalties); and \$12,188.91 (prepetition  
interest). [POC 2-1, Attachment]

28 <sup>3</sup> Hereinafter, all references to the Rules refer to the Federal Rules of Bankruptcy Procedure, unless otherwise specified.

1 Prior to the claim objection hearing, the Court issued her Tentative Ruling that: (1)  
2 the IRS had conceded that \$103,332.70 of its Secured Claim is for “penalties” and thus, this  
3 portion of the Secured Claim may be avoided pursuant to § 724(a) and the lien preserved for  
4 the benefit of the estate; (2) the Court was unclear whether the \$12,188.91 “interest”  
5 component of the Secured Claim represented interest on taxes, or interest on the penalties,  
6 and resolution of this remaining dispute would require supplemental evidence and a  
7 continued hearing; and (3) that this remaining dispute could be resolved as a contested  
8 matter through the claim objection without filing a formal adversary proceeding [ECF No.  
9 86].

10 The Trustee submitted on the Tentative Ruling and withdrew her objection to the  
11 characterization of \$12,188.91, conceding that this amount represented interest on the taxes  
12 which she could not avoid or subordinate. [ECF No. 87] The IRS did not challenge the  
13 Court’s substantive ruling. However, it was unwilling to submit on the procedural portion of  
14 the Tentative Ruling that the Trustee’s challenges to its Secured Claim could be resolved in  
15 a claim objection. The IRS argued that permitting parties to resolve disputes regarding the  
16 nature/priority of liens and subordination of allowed claims in the procedural context of a  
17 claim objection, without proceeding by an adversary proceeding, would cause material  
18 prejudice to the government and to private creditors.

19 At the close of the hearing, the Court took this procedural issue under submission.

### 20 III.

### 21 LEGAL ANALYSIS

22 Rule 3007 governs claim objections. Per Rule 3007(b), “[a] party in interest shall not  
23 include a demand for relief of a kind specified in Rule 7001 in an objection to the allowance  
24 of a claim.” Rule 7001 sets forth the types of matters to be brought via an adversary  
25 proceeding, including proceedings to (i) determine the validity, priority, or extent of a lien  
26 or other interest in property; and (ii) subordinate any allowed claim or interest. *See*  
27 Fed.R.Bankr.P. 7001(2) and 7001(8).

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1 Here, Trustee's objection to the Claim asserts that a portion of the Secured Claim can  
2 be subordinated and/or the lien avoided because it is for a penalty or interest on a penalty.  
3 The Court agrees that disputes of this nature are not properly decided in the context of a  
4 claim objection because they are adversary proceedings. The Court made a pragmatic  
5 procedural ruling because the IRS' opposition had conceded that \$103,332.70 of its Secured  
6 Claim is penalties. As a matter of law, a lien for penalties can be avoided and the penalties  
7 claim subordinated, which the IRS did not appear to dispute. Thus, it appeared that only  
8 \$12,188.91 of the Secured Claim was truly contested. The Court weighed the expense and  
9 delay of proceeding by formal adversary proceeding, and the relatively small amount in  
10 dispute, with the fact that the IRS had already appeared and was vigorously defending the  
11 claim objection.<sup>4</sup> The Court made the decision that it would be more efficient to resolve the  
12 remaining dispute in this claim objection and, if necessary, by evidentiary hearing. The  
13 Court stated in her Tentative Ruling that an adversary proceeding is generally required;  
14 however, in this case, resolving the remaining dispute over the classification and treatment  
15 of roughly \$12,000 in a contested matter is not inconsistent with substantial justice. Doing  
16 so would not affect the IRS' due process rights where the IRS has vigorously defended the  
17 claim objection and has had the opportunity to be heard on the matters in dispute. *See In re*  
18 *Downey Regional Medical Center-Hosp., Inc.*, 441 B.R. 120, 127 (9th Cir. BAP 2010) (if  
19 the absence of a formal adversary proceeding did not cause prejudice, form should not be  
20 elevated over substance).

21 However, the IRS in oral argument expressed concern that the Court's ruling sets a  
22 precedent for future disputes that prejudice the government, or other creditors, by waiving  
23 the benefits and formalities of an adversary proceeding and forcing them to defend future  
24 Rule 7001 disputes through a less formal claim objection or other contested motion. The  
25 Court acknowledges the IRS' concern. The Court had no intention of setting a precedent  
26 that a claim objection is a procedural substitute for a formal adversary to determine the  
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28 <sup>4</sup> Additionally, the IRS' opposition indicated that the parties were discussing settlement. [ECF 77-1, Pg. 4]

1 validity, priority, or extent of a lien, or to subordinate an allowed claim. The Court has  
2 reviewed the applicable Rules, and they clearly provide that a demand for this type of relief  
3 cannot be made in a claim objection because they are adversary proceedings. See Fed. R.  
4 Bankr. P. 3007(b); Fed. R. Bankr. P. 7001(2) and 7001(8).

5 However, the Court does not foresee that a formal adversary proceeding will change  
6 the substantive outcome. In the interests of economy, the Court encourages the parties to  
7 settle this dispute. If the parties are unsuccessful, then the Trustee must proceed by  
8 adversary proceeding to avoid/subordinate the IRS' Secured Claim.

9 **IV.**

10 **CONCLUSION**

11 For the foregoing reasons, the Court vacates her Tentative Ruling that permitted this  
12 dispute to proceed by way of a claim objection, or as a contested matter, and instead holds  
13 that an adversary proceeding is the proper vehicle to avoid/subordinate the IRS' secured  
14 claim in this matter. The IRS is directed to prepare and lodge an order in accordance with  
15 the revised holding contained in this Memorandum Decision.

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19 DATED: April 15, 2021



Louise De Carl Adler, JUDGE  
United States Bankruptcy Court

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TOTAL: 1